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SUBJECT: INFLATION AND NARCOTRAFFICKING WORRIES IN ZACAPA

REF: GUATEMALA 387

Classified By: Charge d'Affaires David E. Lindwall for reasons 1.4 (b&d ).

#### Summary

1. (C) Weak rule of law and rising inflation are taking a toll on economic activity and citizen security in Zacapa, an eastern department of Guatemala wracked by narcotrafficking. An unprecedented March 25 gun battle between Mexican and Guatemalan narcotraffickers that killed eleven has left Zacapa citizens feeling jittery, even though most are confident they can stay out of harm's way. Local police reportedly are understaffed and corrupt. Guatemala's high inflation rate is further aggravated in Zacapa by narcotraffickers' purchasing power, and local leaders are concerned about possible popular backlash against rising prices. Despite the problems, many businesses continue to operate profitably in the area. A long-delayed, major U.S. hydroelectric project is now getting underway after management mollified local opposition. End Summary.

#### Wanted: Rule of Law

2. (C) Zacapa Governor Mario Rene Franco, of the governing UNE party, told Pol/Econ Couns and Econoff that local police were understaffed, corrupt, and ineffective. He said he did not trust them to provide his personal security, and had a much better working relationship with the local Army commander than he did with the police. The March 25 shoot-out among Guatemalan narcotraffickers and Mexicans associated with "Los Zetas" allegedly contesting control of local drug routes that left eleven narcotraffickers and bodyguards dead at a local recreation area (reftel) demonstrated the inadequacy of police efforts to maintain law and order. While the turf battle between heavily armed narcotraffickers generated a sense of insecurity among citizens, Franco said, common crime had remained "under control." Zacapa City Mayor Edgar Orellana of the opposition Patriot Party agreed that common crime remained at manageable levels, but said he thought local police were doing a satisfactory job.

3. (C) Senior local police officer Salguero said that local crime levels had remained constant despite the spike of narco-activity in the area. Salguero was unsure of the origins of the March 25 melee, saying it "could have been anything ... it's hard to say." He observed that there is regular traffic through eastern Guatemala of drugs, arms, and people (mostly Central and South Americans on their way to the United States). Most homicides in the area were revenge killings, "not something we usually get involved in," he said. Salguero added that many Zacapa Department police officers had been transferred to Guatemala City to confront the crime wave there, leaving Zacapa police under-manned. (Note: In a separate conversation with Pol/Econ Couns, Deputy National Civilian Police Commander Henry Lopez confirmed that

the Zacapa Departmental police had been reduced to 40 officers -- 60 had been removed for cause, and many others had been transferred to the capital.) Salguero said that he and local police deal only with simple crimes, and that white collar crimes, corruption, and narcotrafficking are handled by specialized units based in Guatemala City. Asked whether these specialized units were active in Zacapa, he said no, with the exception of the PNC's counter-drug unit.

#### Inflation to Threaten Public Order?

14. (C) Zacapa had recently seen an increase in small demonstrations against rising fuel and transportation costs, Salguero said. While these were not yet of a magnitude to threaten public order, he anticipated they would grow along with increasing inflation. Both Mayor Orellana and Governor Franco separately described the local economy as "terrible," with both anticipating more frequent demonstrations of rising discontent. Orellana and Franco concurred that remittances from the U.S. were critical to keeping the local economy afloat, but that the area paid a social cost for the absence of a parent from many homes. Hard economic times have also impacted local commerce. The owner of the "Big Shot II" gun shop, which offers, among other items, sawed-off shotguns and Chinese knock-offs of the AK-47, said sales had slowed "because people are spending more on food and fuel."

#### Business Leaders Fear Inflation and Drug Trafficking

15. (SBU) Fernando Garcia Salas, the general manager of local Zacapa melon exporter "Frutas Mundial," told Embassy officers that the two biggest threats to agricultural exporters in Zacapa were cost inflation and drug trafficking. Spiking food and energy costs were squeezing Frutas Mundial's margins. Garcia Salas hoped to pass along the increased costs to consumers in the United States. However, Garcia Salas noted that the price-demand relationship for melons was fairly elastic, making it difficult for Frutas Mundial to raise prices without losing substantial sales volume. He worried that the slowdown in the United States would lead U.S. consumers to curtail purchases of non-staple food items such as melons. When asked about CAFTA-DR's impact on Frutas Mundial's exports, Garcia Salas said that the elimination of tariffs for his products was positive, but had not had a substantial impact on his business. (Note: The general tariff on melons entering the United States from Guatemala declined from 12.8% before CAFTA-DR to 0% after CAFTA-DR. End note).

16. (SBU) With regard to drug trafficking, Garcia Salas said all the melon producers in Zacapa were concerned about employees or narcotraffickers slipping drugs into their export shipments. He worried that seizures of fruit from his farm could bar him from exporting to the United States, the recipient of 95 percent of his crop. Frutas Mundial had implemented strict security measures, including searching employees when they arrive and filming the packing processes before shipment to prevent drugs from being planted in its melons. Garcia Salas was fairly confident that these security measures were sufficient to minimize the likelihood that drugs would be planted in shipments before leaving the processing plant. However, he thought shipments were vulnerable to drug traffickers during transit to the port and during storage and the loading process at the port itself.

17. (SBU) Luis Fernando Oliva, Production Manager of award-winning "Zacapa Rum," opined that narco-infiltration of the region was a serious problem, even though traffickers generally do not perpetrate violence against ordinary citizens. While "Zacapa Rum" and other legitimate businesses tried to offer competitive wages, Oliva said, their salaries paled in comparison to the incomes generated by the drugs trade. The difference was not lost on young people, many of whom were tempted to seek illicit wealth. Furthermore, competition from wealthy traffickers had driven up local land prices.

¶8. (SBU) Oliva also described Rum Zacapa's business growth as "strong" over the past several years, noting that the company's 23-year old "Centenario" rum had been "discovered" in numerous markets overseas, including the United States, the UK and Germany. The company had experienced double-digit growth over the past several years and had recently concluded a three-year worldwide distribution agreement with British spirits distributor Diageo. Oliva projected the agreement would propel a 200% to 300% expansion in Zacapa's sales over the term of the agreement.

#### U.S. Hydroelectric Investment Set to Proceed

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¶9. (SBU) A long stalled, \$70 million, 32 megawatt hydroelectric project in Zacapa appears set to proceed. The project, known as "Rio Hondo II," is a reconstruction and expansion of a 3-megawatt hydroelectric facility on Guatemala's Hondo River destroyed by Hurricane Mitch in 1998. The Rio Hondo Corporation, owned and operated by Alaska Power and Telephone company, took over the project following the collapse of Enron Corporation and acquired land title and permits from the relevant Guatemalan ministries. Nonetheless, the local mayor and environmental NGO "Madre Selva" (Mother Forest) successfully delayed the project from the planned start date of March 2001. Mayor Felipe Mendez of the GANA party leveraged local fears of the project into three successful election campaigns to obstruct progress. During the campaigns, Mendez played on fears that the dam would lead to scarcity and contamination of local water supplies and a breach in the dam could flood entire communities. Informational campaigns carried out by Rio Hondo corporation had gained little traction. In 2006 a local referendum declared the community's opposition to the project.

¶10. (SBU) However, the local political climate appears to be turning in favor of the project. In 2007, Madre Selva activists left the area, and continued cost increases associated with Guatemala's fuel oil-based electricity network led the national government to initiate new hydroelectric projects. (Note: The \$70 million Rio Hondo project is the largest contribution by a U.S. company to the GOG's effort to increase the amount hydroelectric power in its electricity matrix. End note.) The Rio Hondo corporation also took steps to appeal to local communities. Rio Hondo will build a separate 1MW dam to be operated by the community that will provide approximately \$500,000 per month (a huge sum by local standards) to finance local infrastructure and education projects. Rio Hondo is also reforesting the surrounding area and building additional potable water sources. In 2008, Rio Hondo began hiring local people to conduct preparatory phases of the construction, including land clearance and road building. According to the local manager, Fernando Alonso, Rio Hondo's efforts, and the local demand for jobs, are producing a favorable environment for construction, leaving the mayor isolated in opposition. Rio Hondo is currently working with the Ministry of Energy and Mines to develop a Memorandum of Understanding on the project's social responsibilities. The MOU is intended to afford the mayor political cover for backing down from his opposition to the dam.

#### Comment

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¶11. (C) Zacapa leaders concurred that the March 25 narco melee with military weapons had had little impact on local life, with the exception of dampening tourism. However, most perceived that narcotrafficking threatens public order, distorts property prices and other elements of the local economy, and provides a malignant example for local youth. With just 40 police to cover the entire department, rule of law is tenuous at best in Zacapa. The rigid centralization of the National Civilian Police too often inhibits initiative and action at the local level, and deprives local police of a mandate to take meaningful action against certain kinds of crime, such as corruption and narcotrafficking. Despite price inflation of inputs such as fertilizers, many local

businesses continue to operate profitably in Zacapa. Having apparently overcome most local opposition, "Rio Hondo II" managers are now ready to begin work in earnest on the new dam. This project should make an important contribution both to the local economy and to the GOG's plans to increase hydroelectric power generation.

Lindwall